The General Court of Massachusetts

Interim Report:
Closing the Tax Gap
May, 1995

The House Committee on Post Audit and Oversight
and the
Post Audit and Oversight Bureau

Commonwealth of Massachusetts

HOUSE OF REPRESENTATIVES

HPAO

HOUSE POST AUDIT AND OVERSIGHT BUREAU

ROOM 146 • STATE HOUSE • BOSTON, MASSACHUSETTS 02133-1053

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Introduction

On February 15, 1995, the House Post Audit and Oversight Bureau issued a report estimating the annual Massachusetts Tax Gap at between $1.5 to 2 billion dollars.[1] The Bureau identified a number of enforcement areas that required field audit presence and increased compliance efforts. Publicly, the Department of Revenue ("DOR") agreed with the estimate of size of the compliance problem although it indicated that much of the compliance problem could be attacked through technology.

Since the issuance of the preliminary report, the Bureau has met with a number of officials at DOR and has conducted case studies of the tax audit and collection efforts in the states of New York and New Jersey. The Bureau also surveyed the fifty states on audit and enforcement issues (receiving 41 replies) and interviewed key officials from some of the states judged most comparable to Massachusetts.

The Bureau's review of audit operations of other state revenue departments has substantiated the issues raised in the tax gap report that was issued on February 15, 1995.

The Bureau found that monitoring non-compliance with state tax laws was an ongoing and changing problem for the states. The Bureau found that the most effective way for DOR to address issues posed by the tax gap was to implement an ongoing compliance and enforcement program that would produce regular reports on specific efforts to attack the major elements of the tax gap. The lesson learned from other states was that regular and

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[1] Tax Gap is defined as the difference between taxes owed and actually collected from individuals and businesses.

autonomous evaluation of audit programs allowed audit staff the flexibility to target the most productive areas for field audit.

The Bureau found that other comparable states utilized technology to augment field audit efforts. However, most of the states surveyed indicated that a strong field audit presence was a critical tool in reducing non-compliance. These states indicated that technology while valuable, was not a substitute for face-to-face examinations.

The Bureau's review of DOR found that computers have been effectively utilized in detecting omitted income on documents reported elsewhere, mathematical errors, matching programs and special enforcement projects.

The Bureau also noted that while automation and technology had improved some compliance programs, reductions in audit field personnel had produced significant reductions in audit assessments. The Bureau believes that DOR now recognizes that their new initiatives cannot succeed without an increased commitment to field audit personnel particularly in the multistate area.

The Bureau found that the largest revenue producing audits often take more than a year to complete and that a small number of cases generate very large assessment dollars. As evidence of recent trends and findings in this area, see attached letter from DOR dated April 25, 1995. (Appendix I)

<u>Interim Findings and Recommendations</u>

The Bureau has discussed its findings with representatives of the Massachusetts Department of Revenue and reports the following:

1. The Bureau and the Department agree that the most effective way to narrow the "tax gap" is a comprehensive enforcement program that utilizes a definitive commitment to field audit as well as a full utilization of available technological resources.

2. The Bureau found that the DOR is acting prudently in its commitment to utilize computers and technology as a way of augmenting and enhancing its compliance efforts. The recent DOR reorganization establishing an Operations Research Bureau is very similar to what the state of New York has done. The Bureau understands that this new bureau was announced one month ago and will be finalizing its FY'96 business plan by the end of May.

3. DOR has developed several innovative programs that utilize computer assisted programs to target areas of enforcement and potential areas of non-compliance. DOR has begun a program of targeting professionals with Massachusetts licenses. This program has already collected several million dollars.[2]

4. The Bureau informed DOR that its survey and examination confirmed the initial finding that there is no trade-off between field auditors and technology. Conversations with audit officials in other states confirmed that technology enhances field audit operations, but is not a substitute for them. Audit personnel in other states do not believe that adding field auditors approaches the point of diminishing returns in either the short or mid term.

5. The Bureau recommends that additional funds be appropriated for increased staff commitments for field auditing. The Bureau's review of states with multi-state presence found these out of state audit efforts to be among the most productive for state revenue departments.

6. The Bureau believes that a review of the collective state experience on enforcement and compliance is extremely useful and that all of the Bureau findings be made available to DOR for its review. The Bureau believes that DOR should initiate a more formalized and structured compliance and enforcement reporting program for internal purposes as well as apprising the legislature of its initiatives.

7. The Bureau remains concerned that as budget cycles continue to experience uncertainty, audit personnel become easy targets for downsizing. The Bureau's review has indicated that the investment in audit personnel is a substantial commitment to both resources and training. The Bureau finds that to the extent that audit personnel are subjected to re-hire and layoff on a frequent basis, training and expertise suffer significantly. The Bureau's review found that development of well trained and productive field audit staff is a long term commitment. This commitment can be jeopardized if subjected to downsizing during periods of fiscal restraint.

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[2] The Bureau noted that DOR had created a number of special projects that targeted pockets of non-compliance. DOR had recently initiated a number of projects very similar to those reviewed by the Bureau in New York and New Jersey.

8. The Bureau found that building an effective field audit staff was accomplished through adequate training, hands-on management supervision, and appropriate career advancements.

9. The Bureau finds that a return to FY'91 audit levels at DOR would be a significant step in addressing challenges posed by the tax gap. These additions coupled with a properly focused audit program enhanced with new technology would be a positive step in addressing issues posed by the tax gap. The Bureau believes however, that to be the most productive, "phased-in" additions to the Audit Bureau must be made. Adequate management support is essential to productivity and the Bureau recommends that any additions to audit personnel be staffed with additional managers on a 1:4 ratio. The Bureau also believes that the principal focus of additions to the audit staff must begin in the Multistate unit. DOR agrees that without appropriate management support, the simple addition of more audit positions will not result in the desired assessment targets.

10. The Bureau and the Department agree that with the advent laptop computers, high speed modems and other technology, additional multistate auditors can be hired from specific locations rather than assigned to one of the existing multistate offices. Hiring "satellite" auditors will reduce the amount of money that would be spent on office overhead and will allow more multistate field auditors to be hired.

11. The Bureau believes that comprehensive tax compliance efforts are critical to fiscal stability. The Bureau recommends that DOR submit quarterly reports on audit programs and collections to the Committees on Ways and Means and Post Audit.

12. The Bureau believes that additional legislative initiatives are needed to narrow the tax gap. The Bureau believes that Boards of Registration must require federal identification numbers on licenses as a key compliance tool. Legislation to improve recordkeeping and preserve trust fund taxes is also essential. The Bureau will explore areas for legislative initiatives as well as DOR's progress on closing the tax gap in its final report.

Interim Conclusions

The Bureau's review of the Department's actions since the issuance of the tax gap report indicate that the Department has taken a number of steps to narrow the tax gap and to improve revenue production. The Bureau has learned that DOR has established a number of management and audit initiatives designed to improve compliance. The creation of new bureaus for Operations Research, Network Planning and Project Management within a

separate division has the potential to make significant contributions to audit production. The Bureau believes that these initiatives, if coupled with targeted infusions of field audit resources can be significant revenue production tools.

The Bureau notes that several of the recent initiatives are very similar to established programs highlighted in the case studies of New York and New Jersey mentioned in this report. These programs are just some of the measures that have been identified as tools in the fight against tax evasion.

The Bureau believes that in the short run, the Department has made progress in addressing some of the key issues raised in the tax gap report. If DOR can begin to phase-in additional multistate and field auditors, many other compliance initiatives can be undertaken. The Bureau believes however that mere additions of more auditors without a strong management commitment to auditing will not achieve the desired goals. Additionally, the Bureau believes that significant legislative initiatives are needed to give the Department all of the tools it needs.

The Bureau offers the attached survey and case studies to support its findings. The Bureau will make these findings available to DOR for review.

Case Study

State of New York
Department of Taxation and Finance
Revenue Opportunity Division

The House Post Audit and Oversight Bureau highlighted the New York Department of Taxation and Finance as a case study as part of its survey of state compliance efforts. As part of its review, staff of the Bureau conducted extensive interviews with the Commissioner of Operations and the Director of the Revenue Opportunity Division ("ROD") (see attached organizational chart of compliance division) The Bureau also toured operational and support facilities at ROD to gain a better understanding of the ongoing compliance and monitoring operation at the State of New York, Department of Taxation and Finance.

In the course of the interviews, the Bureau was briefed on a number of ongoing compliance and technology initiatives developed by ROD. Based upon the Bureau's review of the New York operations, it was apparent that the New York Department of Taxation and Finance has spent a large amount of time in planning and organizing an ongoing compliance strategy. This effort was designed to give up to date assessments of compliance efforts and initiatives as well as to provide an independent and self-supporting research and development unit designed to target areas of non-compliance and to develop strategies and technologically enhanced audit programs. This special unit identifies problem areas as well as develops in-depth analysis of operations that allows audit managers to assess the effectiveness of ongoing audit initiatives and programs.

Based on its review of operations of DOR and other state revenue operations, the Bureau found that New York was unique because it had developed a Revenue Opportunity

Division that was able to operate independently of other divisions (namely audit and operations). The value of this independent and autonomous approach was that ROD could provide ongoing research and systems development independent of audit and data processing. This independence allowed ROD to utilize information, develop its own computer programs, and to establish innovative tax compliance programs and strategies.

The functions of the ROD included:

A. Operations Research and Tax Enhancement Program Development.

- generate ideas, design and manage test projects and turn over successful audit and compliance programs

- develop advanced PC environment, large data base matching programs and concomitant mainframe interface routines

B. Oversee tax information disclosure and governmental coordination.

C. Manage a centralized program for discovering and accounting for sales tax unregistered vendors.

The Bureau noted that these functions, combined with a well designed Management Information System ("MIS"), allowed the New York Department to have a detailed audit plan that could be monitored from a number of crucial points. The program developed by New York's ROD was able to evaluate audit programs and individual auditors based upon time spent, closed cases, percent of agreed issues, unagreed issues, appeals, as well as such features as tax type, audit function, universe of auditees and many others.

The Bureau noted that this ongoing audit review provided audit managers with day-to-day reports if necessary on the productivity of individual audit programs. MIS reports could also be created by district office region, manager or individual auditor.

The Bureau found that this dual approach namely an autonomous ROD, as well as a coordinated MIS allowed New York to develop a strategic model that effectively utilized an

almost unlimited universe of data gathered from a multitude of sources. This universe of computer integrated data was then used by the audit division to support audit efforts by both desk and field auditors.

The Bureau also noted that the information systems developed by ROD were extremely cost effective in that not only did they enhance and supplement audit and field operations, but they provided significant mechanisms to encourage and compel compliance by using third party data, thus obviating the need for full field audits. This strategy allowed New York to maximize the use of its available resources.

The Bureau found however that one recurring theme was that technology was an enhancement to audit and was not meant to be a substitute for auditing. When New York personnel were asked if they could identity a point of diminishing returns on audit efforts, they responded that their computerized system provided opportunities that were almost limitless. The problem was not one of reaching the point of diminishing returns in terms of ROD initiatives and audits, but rather one of physical staffing needs and staff burnout due to increased compliance goals and initiatives. The Bureau found no evidence that commitments of additional resources in these areas would ever approach a diminishing returns in either the short or mid-term.

The Bureau also noted several legislative initiatives that facilitated the effectiveness:

- statutorily mandated third party recordkeeping requirements and use of taxpayer identification numbers on licenses and many other documents
- disclosure functions performed in ROD
- autonomous status for ROD

The Bureau noted that ROD was aggressively utilizing technology to provide a virtually unlimited source of data to be utilized by clerical as well as field and desk audit staff that would greatly improve compliance operations.

ROD had developed program data support for third party recordkeeping that allowed transcripts to be generated based on records of purchases obtained from suppliers and wholesalers. Significantly, ROD had developed its own Electronic Data Processing ("EDP") capabilities which allowed it to automate and integrate the records of third parties. This process facilitated a major compliance effort on auditing cash businesses, such as bars and restaurants. New York personnel noted that there recordkeeping requirements for liquor distributors and other wholesalers also provided substantial support in this area.

Other specific programs targeted by ROD included:

- o elaborate computer matching on non-filers using the IRS, RMV and other state data. These programs generated support for field audits. The first 25 audits generated $75 million in collected tax.
- o others - see attached (Appendix II)

The Bureau noted that part of the ROD's and the MIS's function was to provide a complete data base with substantial historical data so that data which was not currently useful could later be drawn upon for other initiatives. The Bureau was informed that there was available technology and capability to store mega data files on personal computers. The Bureau also noted that because of the increased autonomy of ROD, additional security measures and disclosure protection were incorporated to comply with both New York and federal non-disclosure statutes.

Conclusion of New York Case Study

The Bureau was impressed with both the structure and operation of the New York Revenue Opportunity Division. The Bureau found that a number of the elements of this program should be utilized by Massachusetts. The Bureau has forwarded the results of its findings to DOR for their review. The Bureau has since learned the DOR has contacted New York to discuss their compliance initiatives and has already implemented some of the programs. The Bureau will continue to monitor DOR to evaluate the new initiatives.

Case Study

NEW JERSEY'S SELF-AUDIT PROGRAM

A Demonstration of the Need for Strong Field Presence

May, 1995

The Bureau also examined New Jersey's self-audit program. As part of its review, the Bureau noted the following findings:

The New Jersey Taxation Division designed a self-audit program to collect use taxes from professionals. This program heavily relied upon field audit presence which targeted three specific groups of professionals (lawyers, doctors, dentists), and monitored results within a set time frame. Though the New Jersey Taxation Division did not intentionally survey the importance of field audit presence, the use tax program produced an enlightening overview of the necessity and strength of field audits to improve compliance with tax statutes.

Professional self-auditing methodology began by mailing out general use tax forms for the professionals to fill out and return by a particular date. This mandatory due date was reinforced by the threat of an immediate 7 year field audit for failure to comply. Over a two year period, the Taxation Division systematically addressed dentists, then doctors, followed by attorneys. To promptly create a strong field presence, 50 of the original 200 use tax surveys automatically received a comprehensive field audit. These 50 audits did not include the disciplinary audits of the original 200 surveys for those professionals who completely failed to respond to the original survey. Thus, at least 25% to a possible 50% of the preliminary pool

of auditiees for this program received an actual field audit. According to the New Jersey Deputy Director, this method while not cost effective at the program's outset, became cost effective as word began to spread among professional groups. As the audit completed one professional group and moved to the next, compliance increased on the initial self-audit form, from 10% to almost 80%, according to sources within the Taxation Division. This dramatic increase in compliance within a targeted section of the population demonstrates the potential benefits of strong field presence in procuring voluntary compliance. Though the assessments within the area of use tax cannot be expected to gross as much as other areas (ie corporate tax), New Jersey has witnessed a substantally improved compliance rate, with collections of $80,000-$100,000 per year per auditor for just this program. In addition, the ripple effect of this program has encouraged professionals to buy locally and increased registration of out-of-state wholesalers with the Taxation Division to avoid losing customers to local suppliers.

NEW JERSEY'S AUDIT DIVISION

New Jersey's Audit Division is comprised of 345 auditors at present. Of these, 60 are personal income tax auditors; 60 are Interitance Tax Auditors; 100 are Corporate Tax Auditors; and 125 are Field Tax Auditors.[1]

Usually the first three departments will refer any audit cases to New Jersey's Field Tax division after the particular desk division determines a need to do a comprehensive field audit. Once the field tax division takes over, the auditee receives a full audit for all taxation areas, from personal income tax to corporate excise tax to use tax, depending for which taxes the auditee qualifies. However, NJ has a special certification program by which a departmental desk auditor can increase his/her qualifications from that of a technician to an authorized field auditor. In such a case, the qualified desk auditor can perform field investigations for his/her particular division, instead of referring all cases to the comprehensive Field Tax division. As a particular division increasingly refers cases to the field audit division, the specified tax division may certify an independent group of its own to handle the overflow of field cases. Thus, each desk audit department develops its own field audit division out of a proven need. For example, the Corporate Tax division has a number of qualified field auditors in their desk division called a "traveling team", whom aren't desk technicians. Therefore, though New Jersey's official taxation divisions list only 100 authorized field

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[1]It should be noted that New Jersey will hire 100 new auditors in the upcoming year to staff a recent project targeting cash businesses. Most of these auditors will work in the field and have therefore been included in Tables 2 and 3. (See end of case study for more information concerning this developing program).

auditors, this number does not include those desk technicians who are certified for field performance within the specialized division.

According to the Bureau's research, the New Jersey legislature has just authorized the taxation division of the Department of Finance to hire 100 new field auditors for a new program called the Liquor License Audit. The program aims to audit New Jersey's cash businesses, beginning with retail liquor sales. This program was able to receive funding for extra field auditors due to the strong evidence that developed during the use tax program. This evidence suggested that a forceful field presence enhances voluntary compliance (see above case study). The Liquor Licensing program should fortify the growing conclusion that, in at least some areas of taxation compliance, technology cannot replace actual field presence.

The Bureau conducted a review of all state revenue departments. 41 States responded as well as the City of New York. The following summaries are some of the major findings:

General Conclusions To Bureau's Tax Gap Survey[1]

TABLE #1
TAX GAP COMPLIANCE REPORTING

A. 12 of the states considered most similar to Massachusetts produced some type of a yearly tax gap compliance report in the past 3 years.

B. Of that 12, 11 produced tax gap reports on an ongoing basis.

C. Only 1 state similar to Massachusetts, Illinois, was in the process of compiling their department's first tax gap report ever at the time of the survey.

D. Of the 11 states that produce tax gap reports continually, only 2 states (North Carolina and Minnesota) relied solely upon IRS yearly estimates to create these reports.

E. Thus, 9 of the 11 states similar to Massachusetts that produce tax gap reports continually compile these reports through targeted independent studies and/or comprehensive tax gap estimates for the entire economy of the state.

TABLE #2
OUT-OF-STATE AUDIT PRESENCE

A. Of the 17 states comparable to Massachusetts, 12 have an out-of-state presence.

B. Of that 12, 9 states have between 10 and 26% of their taxation department engaged in out-of-state audits.

C. Of that 12, 3 states have between 1 and 9% of their taxation department engaged in out-of-state audits.

D. Only 5 states comparable to Massachusetts have no out of state presence at all.

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[1]The Bureau identified 17 states responding to the survey as being fairly similar to Massachusetts, either due to similar tax structures or size and economy.

TABLE #3
DESK VS. FIELD AUDIT PRESENCE

A. Of the 17 states comparable to Massachusetts, 15 have more field auditors than desk auditors.

B. Of these 15 states with greater field than desk personnel, 12 have 75% or more of the total audit staff, including administration, devoted to field work.

TABLE #4

Of the 17 states comparable to Massachusetts, 11 have enacted special legislation or enforcement programs in the past 3 years. Of those programs, the Bureau recommends taking note of New York's ROD program; New Jersey's Nexus program, Self-Audit program, and Liquor License program for its investigation of a broad base of cash businesses; Pennsylvania's RED program.

TABLE #5
MONITORING AUDITOR PRODUCTIVITY

A. Of the 17 states comparable to Massachusetts, 16 states monitor their auditors' productivity annually, if not more often.

B. Of that 16, 10 states evaluate their auditors based on $ amount assessed per auditor.

C. Of that 16, 3 states evaluate their auditors using other methods instead of $ amount per auditor per year.

D. Of that 16, 3 states gave no specific details as to the methodology of monitoring auditors but responded that they do evaluate auditor productivity.

Table 1

States doing any compliance tax gap report in past 3 years	Type of study done to measure the tax gap	When study last completed
California	yearly report released July of following year	1993
New Jersey	by specific project and by overall department	continually
New York	continually	constant reassessment of audit and compliance (see case study)
Texas	quarterly	November 30, 1994
Delaware (Business Audit Bureau)	Targeted industries	annually
Illinois	Sales and use tax compared to regular taxpaying populous	conducting 1st study presently
Colorado	statistically grade account by industry grouping	1988 comprehensive report--condensed report every other year.
West Virginia	periodically	1993
Iowa	sales tax study	1993
Indiana	yearly report of entire estimated tax gap for state	1994
Maine	general estimate using IRS %	every 6 months since 1990
Oklahoma	1st time	September 1994
Mississippi	1st time	November 1994
Kentucky	delinquency rates and audits done	continual
Virginia	non-filer determinations and delinquency rates	continual

States doing any compliance tax gap report in past 3 years	Type of study done to measure the tax gap	When study last completed
North Carolina	Estimates with IRS data	yearly
Alaska	Corporation income tax done continually. Seasonal reports of compliance for fisheries tax.	annually and seasonally
Montana	Estimates with IRS data	yearly
Oregon	Estimates with IRS data	yearly
Missouri	"no-find" audits compared to audits giving assessments	continual
Alabama	Ad Valorem Tax Division assessment sales ratio	yearly
Minnesota	Income tax estimate with IRS data. Sales tax estimate with selected business sector	yearly
Florida	targeted studies	several times in past 3 years.
Utah	ratio specific reports and "optimal audit coverage and staffing plan.	yearly

23 of the 41 states responding have done a tax gap evaluation in the past 3 years.

NOTE: New York City's Department of Finance compiled formal yearly studies of NYC's Underground Economy until 1988.

Table 2

States	# auditors out of state	% auditors out of state of total (includes administration)
New Jersey	21	5 percent
Minnesota	48	14 percent
Iowa	12	18 percent
Indiana	25	14 percent
Alabama	12	3 percent
Kentucky	0	0
California	149	18 percent
Louisiana	39	18 percent
Maine	0	0
New Mexico	0	0
Wisconsin	15	5 percent
West Virginia	0	0
Mississippi	0	0
Virginia	34	16 percent
Colorado	4	5 percent
Rhode Island	0	0
North Carolina	11	3 percent
Vermont	0	0
Arkansas	0	0
Idaho	0	0
New Hampshire	0	0
Alaska	0	0

States	# auditors out of state	% auditors out of state of total (includes administration)
Delaware	0	0
Michigan	53	23 percent
Montana	0	0
South Dakota	0	0
Nebraska	5	0
Tennessee	29	10 percent
Illinois	45	23 percent
Hawaii	9	0
Oregon	5	3 percent
Missouri	35	8 percent
Oklahoma	1	.6 percent
Maryland	6	4 percent
Florida	233	26 percent
South Carolina	9	5 percent
Texas	45	8 percent
Utah	3	2 percent
New York*	220	11 percent
Pennsylvania	0	0
Georgia	0	0

A) 29 of 41 states had 10% or less auditors out of state
B) Only 3 states had 20% or more auditors out of state; Michigan, Illinois and Florida.
C) 6 states had between 11%-19% auditors out of state; Louisiana, California, Minnesota, Iowa, Indiana, Virginia.

* Not all of these auditors live out of New York State, but all travel consistently out of state. The Department of Taxation and Finance found that out of state offices had too high of a personnel turnover to warrant spending for recruiting and training. Determined funds were better used on in-state employees to travel out of state than set up out of state offices. Still have an operational Chicago office.

NOTE: New York City's independent Department of Finance has 13 auditors stationed in Illinois and California. This is 3% of New York City's total # auditors.

Table 3

States with majority as field auditors	# field auditors	# desk auditors	% field versus total	Total # auditors
New Jersey*	230	220	52%	150
Maryland	120	0	85%	150
Florida	700	192	78%	892
South Carolina	117	60	66%	177
Texas	504	0	100%	504
Utah	93	29	76%	122
Iowa	64	42	61%	110
Indiana	120	0	100%	180
Alabama	227	30	67%	334
Pennsylvania	221	0	100%	221
California	1081	0	98%	1152
Louisiana	128	60	60%	212
Maine	64	30	66%	68
New Mexico	99	0	60%	111
Wisconsin	138	0	52%	265
West Virginia	64	0	92%	69
Mississippi	142	24	85%	166
Kentucky	120	0	85%	892
Virginia	206	4	98%	210
Colorado	64	5	92%	68
Rhode Island	40	10	80%	50

States with majority as field auditors	# field auditors	# desk auditors	% field versus total	Total # auditors
North Carolina	168	102	88%	270
Vermont	17	0	77%	22
Arkansas	122	17	97%	139
Idaho	66	0	100%	66
New Hampshire	20	45	57%	40
Alaska	7	0	53%	13
Delaware	12	0	100%	12
Michigan	231	0	100%	231
South Dakota	39	[illegible]	97%	40
Nebraska	34	0	100%	34
Tennessee	208	44	77%	295
Illinois	344	45	88%	440
Missouri	265	175	88%	440
Georgia**	132	5	96%	137

A) 35 of 41 states have more field auditors than desk auditors.

B) More than 85% of those responding to the Massachusetts Survey had more field than desk auditors.

C) Of those 35 states, 23 states devoted 75% of their entire staff, including administration, to field audit positions.

D). New York and Hawaii each devote exactly 50% of their auditors to the field. New York's total number of auditors is 2,062 and Hawaii's total number of auditors is 78.

* New Jersey's statistics vary. See case study.

** Georgia's number of desk auditors does not include those auditors in taxing positions in the Returns Processing Department.

NOTE: New York City's independent Department of Finance has 420 tax auditors, 312 of which are field auditors. Thus, 74% of NYC's Audit and Enforcement Division is comprised of field auditors.

NOTE: Only Montana and Oklahoma have more desk than field auditors. Oregon and Minnesota gave non-conclusive answers to the number of field auditors.

Table 4

States that have enacted special legislation or new programs in past 5 years	Type of legislation or program enacted
New Jersey	1. 2 year old Self-Audit Program 2. Interagency Cost Recovery Task Force 3. Privatization Program 4. Liquor License Audit (funding for 100 new field auditors)
New York	ROD Program (Revenue Opportunity Division -- see case study)
Rhode Island	1. Joint effort with IRS for cash businesses in beach areas. 2. Nexus unit for out-of-state agencies liable for RI taxes.
California	SWAP Meet Enforcement Program in 1993 to track sales and use taxes of cash business
Pennsylvania	RED unit (Revenue Enforcement/Discovery) to discover/collect tax revenue from un recognized sources, especially non-registered businesses.
South Carolina	Nexus program:major impact in last 3 yrs.
Kentucky	1. Criminal Investigation Section 2. Post Audit Program 3. "Market Segment" Audits
Missouri	1. Nexus/Discovery Unit interfaces with IRS and Multistate Commission's nexus database. Also registers "transient employees" and collecting withholding taxes on non-resident athletes and entertainers 2. Pilot project with IRS for joint audits of businesses in high industries (retail, liquor)
Texas	Revenue Opportunity Program

States that have enacted special legislation or new programs in past 5 years	Type of legislation or program enacted
Oklahoma	1. In-house audit program 2. Smaller Sales Tax Gap
Iowa	1. Taxpayer Bill of Rights 2. Federal/State MVF Enforcement Program 3. Self-Audit Program 4. Audit Resolution to reduce # formal appeals
Nebraska	Expanded Nexus investigation
Wisconsin	1. Discovery Unit 2. Self-Audit Program
West Virginia	Excise tax unit for cigarettes, soft drinks, wine, motor fuel, IFTA, IRP
Vermont	Current legislation pending to increase enforcement staff
Maine	1. March 1994 contract collection agency opened office in Augusta for account resolution, customer service, collection services. 2. 1994 legal proceedings against taxpayers payment checks of insufficient funds. contracted with Sheriff's Assoc. staff to contact delinquents directly. 3. 1993 contract with private collection agency. 4. 1994 worked with IRS for dyed fuel legislation. 5. 1992 Joint Installment Agreement

States that have enacted special legislation or new programs in past 5 years	Type of legislation or program enacted
New Mexico	1. 2 auditors training with IRS on compliance assisted auditing for EDI environment. 2. 1 employee developing ANSI standards 3. Federal Mineral Management Service funding 100% self-audit program from which New Mexico will receive 1/2 revenue gained 4. International Registration Program-`94 5. International Fuel Tax Agreement/IFTA 6. Taxation and Revenue Information Management Project.
Minnesota	1. Governor's Program 2. House Audit Program 3. House Collections Program 4. Department Audit Program 5. Department Information System Support 6. Department Taxpayer Service Program
Georgia	Withholding legislations on non-resident partners and real estate owners.
Indiana	1. Criminal Investigation of non-profit organization for non-registration. 2. Self-assessed use by business corp-orations who have skipped filing one year.
Alabama	1. Project for contractors' compliance. 2. Project on unclaimed property taxes.
Louisiana	Legislation RS 33:2847 1993; with-hold funds from parish, municipal, and permitting agencies for non-compliers of non-resident contractors, enforcing registration.

NOTE: New York City's Division of Finance has created enforcement programs such as:

1. Criminal Summons Project (Commercial Rent Tax non-filers)
2. Cigarette Smuggling Prevention Project
3. Personal Income Tax Vacation Hideaway Project

Table 5

States measuring auditor productivity	Method of measuring auditor productivity
Utah	1. # audits completed, # hours per audit, amount $ assessed per auditor per FY. 2. Audit survey per taxpayer that receives an audit. Subjectively evaluates auditor into general database Follow up each negative survey. Customer service for taxpaying public.
New Jersey	1. $ per auditor per year
New York	1. Assessed per year per ROD department (see case study).
Rhode Island	1. $ per auditor per year.
Pennsylvania	1. # of assignments, # of assessments, $ amount yield per audit hour per audit and per FY.
California	1. Audit type (business classification). 2. Auditor classification in FY.
Louisiana	1. # cases completed, $ amount of audit assessments, $ amount per auditor per month.
Maine	1. Developing new tax accounting system to measure regularly auditor productivity.
New Mexico	1. $ per auditor, $ per audit hour. 2. Abatements, deactivations, protests, bankruptcy, collections. 3. dollars earned per dollars spent.
Georgia	1. # audits completed, # hours, # non-audit hours. 2. $ amount assessed.
Iowa	1. $ amount collected per auditor. 2. $ amount earned by department versus $ amount spent on enforcement.
Mississippi	1. $ amount per fiscal year
Kentucky	1. # hours and $ amount per audit completed.
Virginia	1. # audit hours and $ amount per hour.

States measuring auditor productivity	Method of measuring auditor productivity
Indiana	1. % time in field to total hours to complete particular audit. 2. # cases completed per year.
Vermont	1. $ amount collected per desk auditor per year. 2. $ amount collected per field auditor per year.
Arkansas*	1. # audits done per auditor
Alaska	1. # cases worked and $ amount assessed.
Delaware	1. $ amount collected, case amounts. 2. Difficulty of enforcement assignment.
Montana	1. Individual income auditors $ per year per auditor. 2. Corporate income auditors $ per year per auditor.
South Dakota	1. $ per auditor per year in sales, use, contractor's excise, fuel tax divisions.
Nebraska	1. # hours per audit per year. 2. $ amount per audit per year.
Oregon	1. PIT department by desk versus field $ amount per auditor. 2. Corporate and Estate by desk versus field $ amount per auditor.
Missouri	1. Field Audit Bureau auditors evaluated subjectively annually. 2. Monthly report of # audits, amount $ assessed by audit tax type.
South Carolina	1. Monthly reports of cases closed, assessment of collections, direct audit time on the case.
Maryland	1. $ per hour basis
Oklahoma	1. $ per auditor per year in field audits. Compiled per month for review.
Texas	1. $ amount assessed per in-state auditor per year. 2. $ amount assessed per out-of-state auditor per year.
Minnesota	1. $ amount collected per program yearly.
Florida*	1. Yes but not based on $ per auditor because violates taxpayer laws.

States measuring auditor productivity	Method of measuring auditor productivity
Alabama	YES BUT NO FURTHER EXPLANATION OF METHOD
Wisconsin	YES BUT NO FURTHER EXPLANATION OF METHOD
West Virginia	YES BUT NO FURTHER EXPLANATION OF METHOD
Colorado	YES BUT NO FURTHER EXPLANATION OF METHOD
North Carolina	YES BUT NO FURTHER EXPLANATION OF METHOD
New Hampshire	YES BUT NO FURTHER EXPLANATION OF METHOD
Tennessee	YES BUT NO FURTHER EXPLANATION OF METHOD
Illinois	YES BUT NO FURTHER EXPLANATION OF METHOD
Hawaii	YES BUT NO FURTHER EXPLANATION OF METHOD

* Michigan, Idaho, Arkansas and Florida have Taxpayer Rights prohibiting $ amount assessments per auditor as a method of evaluation. Therefore, Michigan and Idaho have no auditor specific evaluation program. Arkansas and Florida do have evaluation programs, but not based on $ amount collected.

NOTE: Also received separate taxation response from New York City. Their department of Audit and Enforcement Division calculates # audit assessments per auditor each month through fiscal year.

STATES CONSIDERED COMPARABLE TO MASSACHUSETTS

NEW JERSEY

NEW YORK

CALIFORNIA

DELAWARE

ILLINOIS

INDIANA

NORTH CAROLINA

MINNESOTA

FLORIDA

TEXAS

VIRGINIA

WEST VIRGINIA

MICHIGAN

RHODE ISLAND

LOUISIANA

GEORGIA

PENNSYLVANIA

Appendix #1

The Commonwealth of Massachusetts
Department of Revenue
Leverett Saltonstall Building
100 Cambridge Street, Boston 02204

MITCHELL ADAMS
COMMISSIONER

April 25, 1995

Thomas W. Hammond, Jr.
Director and General Counsel
House Post Audit and Oversight Bureau
State House, Room 146
Boston, MA 02133-1053

Dear Mr. Hammond:

In response to your request for information dated March 3, 1995 I provide the following:

Request:

1. *Audit [relating to actual audit assessments for FY93-FY94 and projected audit assessments for FY95].*

Response:

	FY93 Total	FY94 Total	FY94 Feb. YTD	FY95 Feb. YTD
Bureau of Desk Audit	26.998	30.758	21.053	13.307
Multistate	86.173	73.639	50.122	37.147
New England Audit Bureau	116.288	102.597	56.077	82.996
Computerized	289.397	295.669	230.040	242.337
Total	518.856	502.662	357.291	375.787

Notes to Table: 1. All amounts in thousands of dollars.

The FY95 DOR performance target for total assessments is $527 million. (We have not established performance targets at a lower level of detail.)

Request:

The Committee also requests that the DOR explain how computers are used in the audit process other than simply generating the bills derived from annual audit where an NIA has already been issued. If there are assessments that are generated solely by an automated system, please explain each and every type. For instance, if a computer match reveals income reported on a 1099 that is not included in a taxpayer's Massachusetts gross income, how does the DOR make an assessment in

that case? Does the taxpayer first receive a NIA and then later receive a bill? Please explain in detail.

Response:

In general, computers are used to identify discrepancies between tax return information and other information available to the Department. Depending upon the kind of discrepancy identified, the taxpayer may be asked for further information to confirm or refute the need to file or to pay additional tax and may be subject to notification of failure to file, notification of an intent to assess, notification of assessment, wage or bank levy, or other enforcement actions. Such actions may be initiated by enforcement personnel or by automated routines.

Three categories of activity may trigger an automatically generated Notice of Assessment: 1) MASSTAX production routines that identify a discrepancy between the amount of tax liability self-assessed by the taxpayer (on initial or amended returns) and amounts actually received in payment; MASSTAX CP2000 routines that identify a discrepancy between the amount of tax liability self-assessed by the taxpayer and a computer calculation of liability taking into account the result of IRS audit findings; and special enforcement projects that utilize computerized data matches and computations to identify additional tax liabilities. In the CP2000 program, an NIA is generated prior to the issuance of an NOA.

The degree to which special enforcement projects are automated has increased over time.

Up until relatively recently, many special enforcement projects were done primarily by hand or with limited computer support. For example, Audit Division personnel would routinely request that lists of corporate audit candidates be generated by computer, based upon "business rules" that were intended to identify for particular industry groups those returns with unusual relationships among their line items. Audit Division personnel would then conduct further manual lookups and investigations to refine those lists prior to initiating audit activity. In an eighteen month project conducted jointly by the Audit Division and the Bureau of Analysis, Estimation and Research, more sophisticated computer-based selection mechanisms were developed. These included automated matches of income and transaction tax data, matches of state business tax return data with federal business tax return and registration data, and extensive testing of "business rules" for selection of audit candidates. In this instance, computers were used to support the selection process and, in those cases where a match uncovered a discrepancy that translated directly into a greater tax liability, to identify at least a portion of the additional liability to be assessed.

More recently, DOR conducted a matching program in cooperation with the Connecticut Department of Revenue Services that relied more extensively on computerized operations. Connecticut records of individuals with a Massachusetts address who filed a Connecticut income tax return claiming credit for income taxes paid to Massachusetts were matched to records of Massachusetts tax filers. In this project, individuals who had failed to file a Massachusetts tax return or paid an amount different than that claimed on the Connecticut return were identified, and the additional Massachusetts tax liability determined, by computer. The necessary NFF (Notice of Failure to File), NIA and NOA letters were then generated using MASSTAX, which has built in the capacity to generate these notices based upon input of a taxpayer ID, name, address, tax type, period, and amount to be assessed. The project has to date identified 320 individuals who had failed to file and $1.3 million in additional tax, penalty and interest owed.

Computers are also important in assisting our audit effort in other ways. For example, the Audit Division recently completed a project of targeted audits of dentists, which began with a match of Board of Registration in Dentistry records against state tax records to identify potential non-filers. We are in process of providing our field auditors with new notebook computers and software to replace their old laptop machines. The new computers will make it possible for field auditors to

conduct more extensive and uniform audits, and the accompanying new capacity to download audit-related data from the mainframe will free auditors from some manual data entry chores and thus increase the time that can be devoted to more productive audit work. In addition, to deal with the issue of large business taxpayers who conduct almost all their financial transactions, including purchases, electronically, we have begun a program of direct audits of companies' computerized data. While this program is in its infancy, we expect it to become increasingly important in the future. Finally, we are beginning to use computers to track the final outcomes of all our audit assessments. Did the assessment lead to a an abatement, an adverse appellate decision, or a collection? The results of this research will help us to better target our enforcement resources.

The Connecticut project, along with other projects that prove successful, will be scaled up to full MASSTAX production modules that support annual matching and noticing. Computerized support of special enforcement projects, the identification of more such projects that will be cost-effective with expanded support, and the development of production systems are all areas of intensive research and development in the Department. We are in the process of cataloging both completed and planned special enforcement projects that rely on a combination of manual audit and enforcement work, computerized data matching and MASSTAX production capabilities, and would expect to be able to share such information when it has been compiled.

Request:

For the assessments generated by automated computer matching and data matching files, please list the types of matches and amounts assessed for FY'93, FY'94 and FY'95 year to date, and projected. Please also indicate whether or not these assessments are included in any or all of the categories above (i.e., desk audit, etc.).

Response:

In general, the Department uses the term "computerized assessment" to designate an assessment in which both computation of additional tax owed and subsequent noticing of the taxpayer has been initiated by an automated system. The amounts of computerized assessments identified as such are exclusive of the amounts of assessments identified as from other (non-computerized) sources. As I noted above, we are in the process of developing a more comprehensive tabulation of "computer-assisted" assessment projects. Totals for our computerized assessment programs are given below.

	FY93 Total	FY94 Total	FY94 Feb. YTD	FY95 Feb. YTD
MASSTAX-identified	280,369	282,796	223,853	232,385
CP2000-identified deficiencies	8,906	12,873	6,187	9,952
Total	289,275	295,669	230,040	242,337

Notes to Table:
1. All amounts in thousands of dollars.
2. CP-2000 computer-generated non-filer assessment amounts are included in the "MASSTAX-identified" totals; we are unable to break them out at this time.
3. The "CP2000-identified deficiencies" totals include certain assessments which involved some manual audit work. CP-2000 deficiency assessments generated solely via automated procedures were: $0 in FY93, $4.459M in FY94, $1.122M through FY94 Feb. YTD, and $7.757M through FY95 Feb. YTD.

Request:

2. Audit Assessments

Please indicate what percentage of audit assessments listed in response to question one were the result of audits that began in the same fiscal year as the assessment.

Response:

The following percentages reflect activities of the entire Audit Division.

FY'93	28%
FY'94	32%
Feb YTD FY'95	31%

Request:

For each audit assessment of $100,000 or more made in FY'92, FY'93 and FY'94, indicate the date the audit commenced, the date of the NIA, the amount of the NIA and the amount of the assessment.

Response:

In regard to manual audit assessments of $100,000 or more made in FY92, FY93 and FY94, the following summary information is available:

	FY92	FY93	FY94
Number of cases closed	277	323	346
Total NIA amounts	$111.2M	$141.2M	$133.4M
Total assessments	$120.6M	$158.0M	$142.0M

Request:

3. <u>Collections of taxes not remitted by taxpayers when due</u> [relating to delinquent collections, including computer generated collections]:

Response:

	FY93 Total	FY94 Total	FY94 Feb. YTD	FY95 Feb. YTD
Automated wage levy	na	562	1	1,046
Automated bank levy	4,699	6,882	502	5,094
Tax intercept	35,097	36,623	21,886	14,158
Other computerized	142,289	153,943	108,434	106,725
Manual	161,376	187,319	117,147	118,903
Total	343,461	385,329	247,970	245,926

Notes to Table: 1. All amounts in thousands of dollars.
2. "na" denotes not applicable.

The FY95 DOR performance target for collection of delinquent taxes is $402 million. (We have not established performance targets at a lower level of detail.)

Request:

Please also indicate the total amounts collected by the DOR's Enforcement division employees, the breakdown of the total amount of collections for the above-referenced fiscal years, and list separately the amounts generated by private collection companies and employees of the DOR for the same periods.

Response:

	FY93 Total	FY94 Total	FY94 Feb. YTD	FY95 Feb. YTD
DOR employee collections	147,652	165,419	103,263	106,962
Private agency collections	13,724	22,600	13,884	11,941
Collection Division Total	161,376	187,319	117,147	118,903

Notes to Table: 1. All amounts in thousands of dollars.

Request:

Also, please list the number of full-time employees in the Collections Bureau for FY'93, FY'94 and FY'95.

Response:

FY'93	165.4
FY'94	167.3
FY'95	164.8

Notes to Table: 1. Number of regular, active full-time equivalent employees as of 6/26/93, 6/25/94 and 3/18/95.

Request:

Does DOR keep statistics on the numbers of tax due returns for which no payment is received when the return is filed? If so, please provide any statistics for the above referenced fiscal years.

Response:

We are still working on this request and will forward information to you as it becomes available.

Request:

Finally, please provide all current statistics on the amount of collections received from the Bankruptcy Unit for the same periods as referenced above.

Response:

FY'93	11,740
FY'94	11,471
FY'95 Feb. YTD	9,137

Notes to Table: 1. All amounts in thousands of dollars.

In FY94, processing of amounts received on account of current tax obligations of bankruptcy debtors was shifted from the Bankruptcy Unit to the Department's Processing Division. The amounts, not included in the above figures, recorded by the Bankruptcy Unit for this category of collections ($11.639M FY93, $3.225M FY94, and $1.916M Feb. YTD FY95) reflect this shift in administrative practice.

I hope this information provides a start in answering your questions about how the Department is applying new technology, and what results that technology is producing. While in some cases I have not been able to provide information in the exact form you requested, I want to emphasize that we are committed to providing the Committee, and you, with the information you need to fulfill your oversight responsibilities. Please feel free to call my staff directly if you need further explanation of the information provided here.

Sincerely,

Mitchell Adams

C. Major Project Examples

1. Past Fiscal Years

Personal Income Tax Nonresidents

Computer database profiling using computer files from the Department, IRS, NYS Motor Vehicles, States of Florida, Connecticut, New Jersey and Pennsylvania identified thousands of resident individuals who were either not filing, or erroneously filing, nonresident returns.

First 25 audits generated $75 million in collected tax. The Audit Division has adopted this project into an audit program which is generating millions of dollars in collected tax revenue.

Out of State Corporation "Nexus Nonfilers"

A number of projects have been completed which identified out of state corporations doing business in New York State and not paying corporation franchise and/or sales tax. Projects included:

- Crossmatching internal tax files
- Matching internal tax files to Federal, State, local governments' licenses and permits
- Matching internal files to industry directories, trade show participants, periodicals and telephone listings
- Matching tax files to state and local police traffic tickets
- Joint nexus project with 5 northeastern states and Washington, D.C.

Professional Personal Income Tax Nonfilers

Using high-tech computer matching techniques, professionals from license files and directories were identified, profiled and checked for multiple year personal income tax compliance.

Criminal cases were forwarded to the Enforcement Division and the AG Office for indictment and conviction - and civil cases referred for audit. For the balance, letters were used to obtain delinquent returns which resulted in a high success rate.

Millions of dollars were collected from the projects.

Example of professionals checked included:

- Doctors and Dentists
- Lawyers (employees and partners)
- Stockbrokers
- Real Estate Brokers
- Transportation Industry Professionals
- Engineers

Tax Exempt (MUNY Bond) Interest

A two-year test - joint project with the stock brokerage, banking and mutual fund industries and the Audit Division resulted in annual third party information reporting (similar to the IRS 1099) which identifies individuals who underreport interest earned from non-New York State Municipal Bonds on their personal income tax returns.

Test project uncovered an underreporting rate of over 44% and resulted in a computer database matching system which is now used annually by the Audit Division to profile underreporters.

The computer data base is also used to identify nonfilers and nonresident audit candidates. Millions are collected each year using this data.

Yonkers Income Tax Enforcement

The Department administers the City of Yonkers Income Tax. A computer based geographic zip code file was created to identify individuals living in the political boundaries of Yonkers with non-Yonkers post office addresses and non-paying the Yonkers personal tax.

First year, the Audit Division collected over $2 million for the City of Yonkers and uses this file as part of the annual delinquency program.

2. Present Fiscal Year

NYC Peddlers

First phase of the project included a desk audit technique and computer profiling to improve an existing tax clearance process of New York City street peddlers for sales tax.

This resulted in an increase in compliance of 80%. Second phase of the project involves implementing legislation which requires third party information reporting of purchases made by itinerant vendors. Once purchase information is received, a database

will be created to identify nonfiling and underreporting of sales tax by New York City street peddlers, and cost-effective approaches to collect underreporting will be devised.

Liquor Industry

Third party purchases from distributors and wholesalers throughout the state are being used to identify nonfilers and underreporters of retail establishments for sales and income taxes.

Cases have been identified from matching the purchase database to reported sales on returns.

Cases are now being assigned to the Enforcement, Audit and Revenue Opportunity Divisions.

Automobile Repair Industry

Third party purchases from distributors and wholesalers throughout the state will be used to identify nonfilers and underreporters of repair shops for sales and income taxes.

Requests for the purchase information has been made. Fifty percent (50%) of the distributors have not provided the information on the advice of the Automobile Parts Association who had previously filed a court injunction.

The court did not stop us from asking for the information. The Audit Division and ROD are in the process of field and desk auditing of noncompliant distributors to gain the necessary information.

Independent Contractors

Thousands of multi-year personal income tax nonfilers have been identified through a cross-match of IRS 1099 MISC. Profiling potential nonfilers' earned and unearned income is underway. Potential criminal and high income civil cases are being forwarded to the Audit Division.

IRS 1099 MISC - Nexus

IRS 1099 MISC computer file is being used to identify out-of-state corporations who are paying independent contractors in the state as leads into corporation and sales tax taxability targets.

Nonresident Doctors

Department of Education licenses file was used to identify approximately 1,400 nonresident doctors who are licensed and appear to be practicing in New York State. Nexus and income profiles are being developed.

3. Future Fiscal Year

Independent Lawyers

The Office of Court Administration has provided us with a computer file of attorney's names, firm and firm address registered to use the courts.

Single member firms will be selected and profiled for a project to identify nonfilers.

Computer Geographic Information Date Base

Geographic information database software has been ordered which will provide us with the ability to build databases for identifying and profiling businesses on computerized street maps. Potential audit candidates can then ultimately be selected.

Sales Tax Self-Audit Project

Many states have developed programs in which taxpayers are given the opportunity to do "self audits" for sales and use tax.

Using third party purchase information from various other projects, we plan to experiment and develop cost-effective self audit approaches.

IRS/NYS Market Segment Projects

IRS has recently created a new high-tech nonfiler and audit selection organization with two units located in New York State districts.

The units supported by a national office research group will be profiling industry and professional market segments for noncompliance with federal tax laws.

Our plan is to assist and work with the IRS on market segment projects to receive a large number of federal audit changes for corporation/income tax and attack noncompliance in sales and other state taxes.